ASSESSING THE IMPACT ON DEVELOPING COUNTRIES OF ECONOMIC REFORMS IN EASTERN EUROPE

Views of the Committee for Development Planning

Contrary to widely expressed fears, the overall negative effects on developing countries of economic reforms in Eastern Europe are likely to be negligible in the near future in the areas of trade, official aid, private lending and foreign investment, according to a United Nations advisory group of economic and development experts. However, some developing countries, which depended heavily on economic relations with the Eastern European countries in the past, are feeling the immediate crunch. In the long run, once the reforms succeed and economic growth resumes, Eastern Europe will offer opportunities for trade and investment and become a source of capital and technology. Meanwhile, the process of transformation is characterized by increasing uncertainty due largely to the varying economic and political circumstances of the reforming countries.

These are the views of the 24-member United Nations Committee for Development Planning, an expert body on economic and development issues, which met at United Nations Headquarters from 22 to 26 April 1991 to deliberate on the epochal changes taking place in Eastern Europe and their potential impact on developing countries.

PROBLEMS OF TRANSITION

Transforming a well-entrenched planned economy into a fully fledged market economy or market-oriented economy is a task of enormous magnitude and one that is likely to incur significant economic, social and, in some cases, even political costs. The basic foundations of a market economy are missing in the reforming Eastern European countries. These include market mechanisms like commercial banking and various legal instruments which facilitate market functions. Entrepreneurship and a new managerial culture will have to be nurtured. The reforming countries are each very different in their stage of economic development, their starting-point and pace of reform, their political and ethnic background, their size, population and natural endowments, and their economic history—so that there is no single path to or panacea for economic reform in Eastern Europe.

The problems of transition are aggravated by external factors as well. The regional framework of trade and other economic interactions, represented by the Council for Mutual Economic Assistance (CMEA, or COMECON), has collapsed. In 1989, for instance, the European members of that organization conducted 40 to 80 per cent of their trade among themselves. The decision to use world market prices for trade and to settle transactions in convertible currencies as of 1 January 1991 is straining the smooth conduct of trade. The unification of Germany and the resultant disappearance of the German Democratic Republic not only contributed to the collapse of the regional trade organization but also significantly reduced the economic transactions among the reforming countries.

The increasing uncertainty surrounding the Soviet economy and its reform process is also complicating the transition, in that the Soviet Union had been the single largest economic power in the CMEA and the central force that kept the trading arrangements in place for the last 40 years or so. Many countries in Eastern Europe and the socialist developing countries had depended heavily on the Soviet Union for subsidized fuel and raw materials, as well as for receiving their exports of industrial and consumer goods. This trading partner is no longer in a position to maintain economic relations favourable to them. The rise in world oil prices, the economic recession in the industrial countries of the West and the debt burden that has accumulated over the past several years place additional strains on the reforming countries.

All these problems point to the sober realization that the economic reforms in Eastern Europe

are likely to proceed at a much slower pace and in more varied ways than initially anticipated. Consequently, the impact of the reforms on the developing countries as a whole will be smaller than expected and spread over a period of time, except for those countries that maintained close economic ties with the Eastern European countries.

IMPACT ON SOCIALIST DEVELOPING COUNTRIES

The United Nations group of experts finds that the impact of the changes taking place in Eastern Europe is most serious in Cuba, the Democratic People's Republic of Korea, Ethiopia, Mongolia, Mozambique and Viet Nam.

Cuba, for instance, depends heavily on the Soviet Union for its sugar exports and fuel supply. Raw sugar accounts for 91 per cent of total Cuban exports to the Soviet Union. While it is anticipated that the Soviet Union in 1991 will still pay twice as much for Cuban sugar as the world price to preserve economic relations with Cuba, the Soviet demand for payment for its fuel and other export items on time and in hard currency places a heavy burden on Cuba. The level of trade and economic transactions between the two countries is thus likely to drop significantly in the near future.

Soviet economic ties with other socialist or socialist-oriented developing countries are also likely to undergo substantial changes in both structure and volume. The adoption of world prices and hard currencies for economic transactions has reduced the import and payment capability of those countries. As the Soviet economic performance deteriorates, the volume of Soviet aid and credits is expected to drop sharply. The experts of the Committee for Development Planning estimate that Soviet free aid to foreign countries, which reached $US 3.9 billion in 1988, will drop to $700 million in 1991.

The disappearance of East Germany as a State had an immediate impact on several socialist or socialist-oriented developing countries. According to the Committee, East Germany's official development aid was estimated to be 2.2 billion Valuta-Marks (equivalent to $US 750 million) in 1988. (Note: The estimate of the Organisation for Economic Cooperation and Development (OECD) was $US 184 million.) Of this amount, roughly 60 per cent went to Cuba, Mongolia and Viet Nam, and 30 per cent to other socialist or socialist-oriented developing countries. Due to the implicit division of labour between East Germany and other East European countries in development assistance, the East German assistance was concentrated on some sub-Saharan African countries, such as Angola, Ethiopia and Mozambique.

Since the socialist orientation no longer serves as a criterion for foreign assistance in the unified Germany, the impact of the unification is severe in many of the above-mentioned countries. It is most acutely felt in Cuba, which lost trade with Germany. On the other hand, some countries, like Angola and Mozambique, which had maintained good relations with East Germany, may benefit from the unification.

EFFECTS OF THE ECONOMIC SLOW-DOWN

Slower economic growth, or even some decline in the Eastern European countries, has reduced their demand for imports, including those from developing countries. The introduction of the system of payment in convertible currencies has exacerbated the problem. Many Eastern European countries have been an important market for primary commodities from developing countries, much more so than other goods. Therefore, their agricultural and mineral exports are likely to be adversely affected in the short run, although import liberalization may increase developing-country exports in the long run. Reduced lending to developing countries, including a drastic cut by the Soviet Union, will eventually affect their exports to developing countries.

The economic slow-down has also led to reduced trade among the Eastern European countries, particularly the supply of natural resources from the Soviet Union. However, this may open

up new opportunities for developing countries to export competing products, including oil and a few other primary commodities. The weakening of intraregional trade ties may also benefit neighbouring developing countries through increased trade.

STIFFER TRADE COMPETITION

One noteworthy trend in the trade patterns of the Eastern European countries is that their exports are shifting to the markets of industrial countries, particularly in Western Europe, and this trend is likely to continue, according to the Committee for Development Planning. As a result, exporters of manufactures in the developing countries will face stiffer competition in those markets. This is particularly the case in low to middle-grade technology and manufactured products.

The competitive position of the developing countries *vis-à-vis* Eastern European countries is likely to deteriorate to some extent for several reasons. Increasing direct investment by industrial countries in the reforming countries will gradually boost their industrial production, technology and marketing skills. Industrial countries are also giving tariff concessions to the reforming countries, which already have a competitive advantage in such areas as machine tools and construction machinery.

In some other areas, however, the reforming countries are already at such a disadvantage in the industrial markets that it will be difficult for them to compete with exports from developing countries. This may be the case, for instance, in clothing, some consumer electronics and microprocessors. They are still technologically behind in many areas.

The patterns of trade between the reforming countries and the developing countries are also likely to change. As trade is increasingly conducted according to purely economic rationales, trade partners will shift from economically less successful developing countries to more dynamic industrializing countries.

DIFFERENT IMPERATIVES FOR COMMERCIAL LENDING

Commercial banks in the United States, Western Europe and Japan do not seem to view lending to developing countries as interconnected with or dependent upon lending to Eastern European countries. The view of the United Nations economic experts is that there are different imperatives for lending or not lending to two separate groups of countries.

In the light of the bad loans of the 1980s that could not be recouped, many commercial banks in industrial countries have written off or reduced a large amount of debt owed by developing countries and have been avoiding new lending, particularly medium- and long-term, to most developing countries that have not been performing well economically. Recent banking regulations that have tightened capital and other requirements have also made banks reluctant to engage in new unsecured medium- and long-term lending.

Few banks are also lending to the Eastern European countries on a large scale. The political and economic uncertainty is such that fresh medium- and long-term loans are considered highly risky. In particular, the financial requirements of the Soviet Union are so large that commercial banks naturally are extremely cautious in their lending policy. The success or failure of Soviet reform will have a significant impact on the pattern of overall capital flow into the region as a whole. However, the picture is still unclear.

AID CREATION OR DIVERSION?

One of the major concerns expressed by many developing countries was that official aid might be diverted from developing to Eastern European countries. The Committee for Development Planning finds that, so far, official aid to Eastern Europe has been additional to regular official development assistance (ODA) to developing countries, even though in some cases existing ODA or the growth portion of ODA has been tapped to provide assistance to the reforming countries.

According to OECD estimates, official aid commitments to Eastern Europe for the period 1990-1992 amounted to $US 14.23 billion. This amount excludes financing for the European Bank for Reconstruction and Development. The Committee experts believe that official aid to Eastern Europe could average $4.5 billion per year for the next three years. Aid consists mainly of food, structural adjustment programmes, environmental rehabilitation, industrial investment and debt forgiveness.

The experts are somewhat fearful that the tendency to tap either the growth portion of ODA or existing ODA might grow. For instance, Italy proposed in mid-1990 to raise the European Community aid level to 1 per cent of Gross National Product by 1993 and to allocate half of this aid to the reforming European countries. As far as the question of aid conditionality is concerned, the experts believe that new forms of conditionality are not likely to be introduced.

FOREIGN INVESTMENT NOT YET A THREAT

The Committee experts conclude that while foreign direct investment flows to Eastern Europe have dramatically increased in the last few years, they are not large enough to be a significant competitive threat to developing countries.

Mostly small Western European firms look to the East for investment opportunities rather than to more distant locations in Africa, Asia or Latin America. Large multinational firms seem to approach Eastern Europe as an addition rather than an alternative to investments in the developing countries, and also in a strategic way related to preparations for a single European market.

The Committee experts estimate that cumulative foreign direct investment in the USSR and three Central European countries is about $3.5 billion. The data compiled by the International Monetary Fund show that foreign direct investment inflows world-wide were about $182 billion in 1989. Of this, the share of developing countries was $18.5 billion; China, $3.4 billion.

The Committee notes that Eastern European direct investments in the developing countries have been growing in recent years. The opening up of Eastern Europe to foreign investment has also stimulated investment from the developing countries. This trend is likely to increase.

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